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May 3, 2000 **LETTER 1300**

THE PICTURE: Ned Davis of Davis Research notes in his latest mailing that "one of our major themes for the year 2000 has been that the undervalued bonds might outperform overvalued stocks." That's been my thought, as well, and I've acted on it for my own account.

Davis notes that over the last three months a record $81.6 billion has flowed into stock mutual funds while during the same period $32.8 billion has flowed out of bonds. "Yet would you believe," says Davis, "that the Treasury bonds (up 9%) actually beat the D-J Industrials Average (down 2.5%) and even beat the S&P 500 (up 2%). The average stock in the Ned Davis 6000 data base had a median decline of 0.9% in the first quarter. . . .The out-performance of bonds over stocks could be providing us with a clue that our major theme, that the risk/reward ratio is better for bonds than stocks, could be a good one."

Russell Comment: Today you have the **earnings yield** for the S&P (**earnings** divided by price) at **3.36%,** this against the government-guaranteed actual **cash yield** of a ten-year note at **6%**. As for the notes, at the end of the ten years you're guaranteed to get your principal back. So which of the two, the S&P or the ten-year note, would a prudent investor buy?

According to *USA Today* (April 21), "75% of likely voters own stock. Will the Dow and the Nasdaq be the litmus tests for the presidential elections?" Whoa, you can see that the Clinton Administration, which is intent on getting Al Gore elected, has a serious interest in the stock market behaving in a "friendly" way between now and election time.

And don't we see Fed Chairman Greenspan often pictured smiling and head-to-head with our noble president? All of which makes me think that the Fed will do everything in its power to avoid a market spill (i.e., the bear market expressing itself) between now and the November elections.

But can the Green man actually prevent the bear from sinking his sharp teeth into the stock market? I doubt it. At any rate, it will be interesting to see how much pressure the Clinton bunch can exert on the Fed. The first clear sign of pressure would be the Fed not boosting rates at their May meeting.

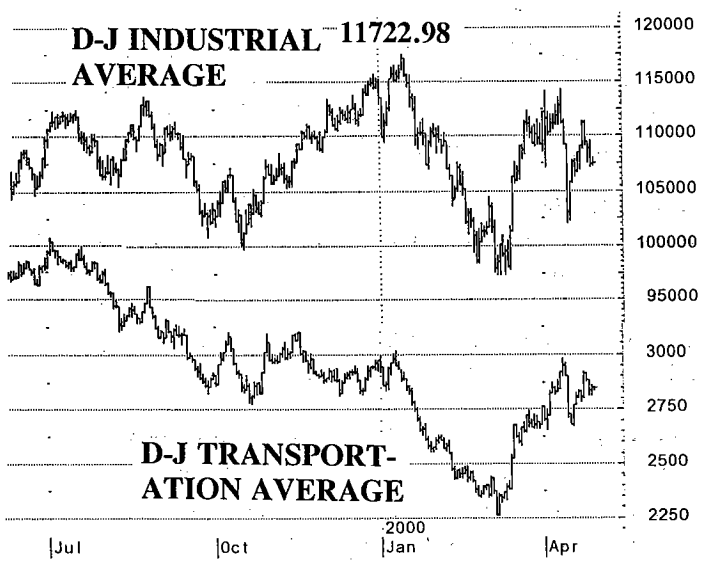
April 14 DJIA 10582.31; PTI 5142; A-D Ratio -7.74
April 21 DJIA 11124.83; PTI 5148; A-D Ratio -7.05
April 28 DJIA 10733.91; PTI 5138; A-D Ratio -7.02
Dow Yield: 1.45%; Dow Price/Earnings: 22.1
Dow Times Book Value: 6.35% ; PTI 89-day exp. MA: 5167
Percentage of Undervalued Blue-chips: 25%
Gold 34-day MA: 284

I'll venture this: If there is any kind of major break in the stock market, Greenspan will use that weakness as a reason and an excuse not to raise rates.

I've said from the beginning that this would be **a bear market of attrition,** and that's exactly what it's been. This patient bear has wandered back and forth from one group of stocks to the next. **The result has been a subtle (and on occasion not so subtle) attrition in the great mass of stocks; at least that's been the story so far.**

One of the tests of this thesis is to observe the list of daily new highs on the NYSE when the Dow undergoes a surge to the upside. Time and time again, for example, we'll see the Dow up 150 points -- with maybe a pathetic 25 or 35 new highs for the day. That's telling us that almost all stocks are now off their highs, some only 5% or 10% while others are down 50%, 70% and more. But as far as new highs -- they're just NOT there.

I want to say a few things about today's wild volatility. In the "old days" I'd buy a stock at say 12 times earnings and yielding 7%. If the stock was of good quality with an excellent long history of good earnings I could sit with that



stock through declines and corrections. If the stock had a well-covered dividend I'd figure, "At worst, in three years I'll collect 21% in dividends, so I can afford to sit with the stock."

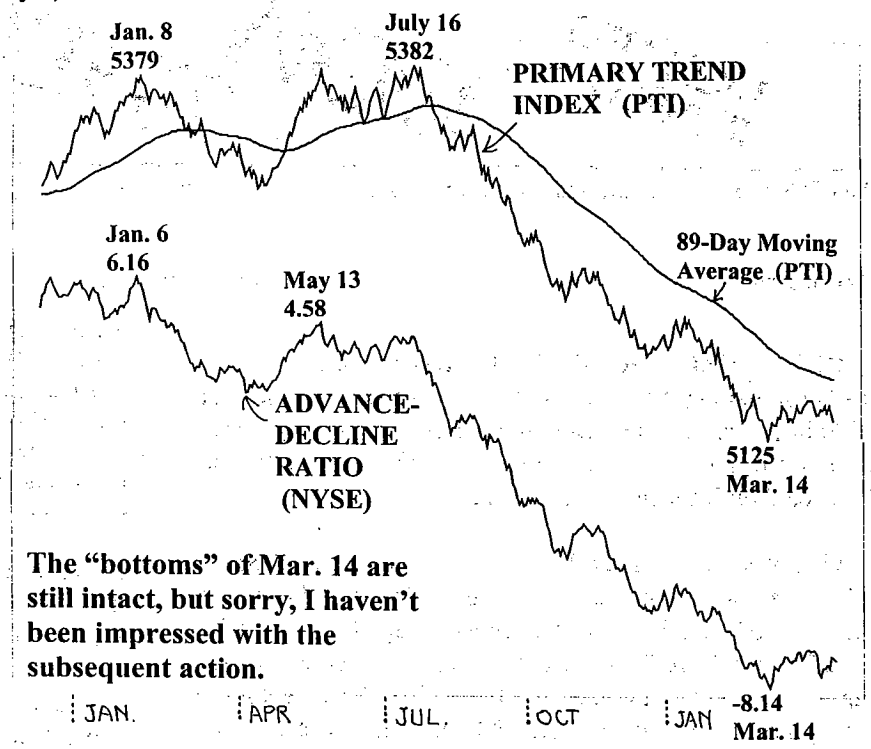
What about today? Today you buy a stock like Qualcomm or Microsoft that has never paid a dividend -- and the stock drops 45% to over 50%. Do you sit? Do you sell? Is there any point in holding the stock, since all it's given you so far is a headache and no income? Not for me there isn't.

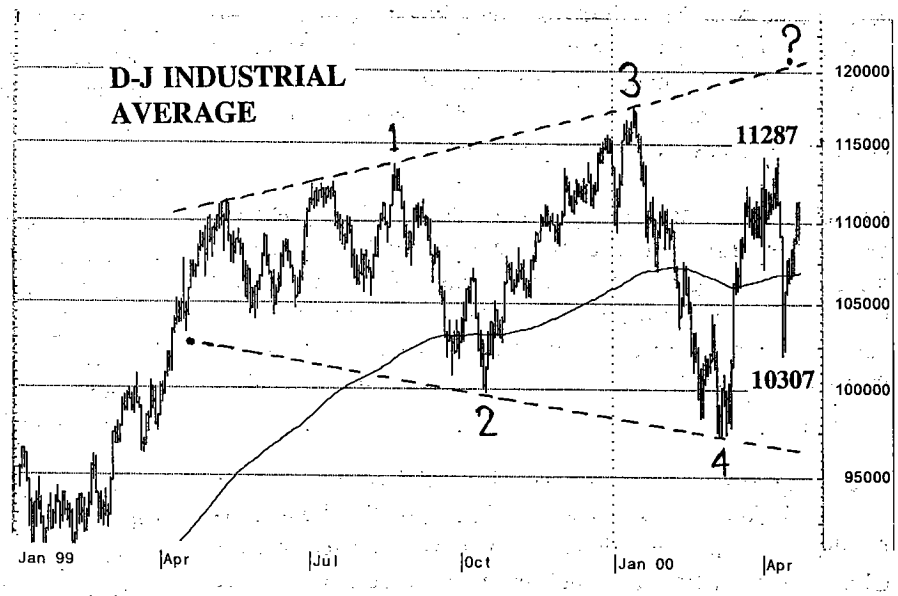
So what happens in today's high-multiple dividend-less market? Everybody rushes in to whatever is going up, everybody goes for momentum. A stock starts to rise because the "whisper number" is a few pennies above analysts' expectations, and everybody pours into the stock. The stock is up 25% in a week. Then the earnings come out and they're a penny below "expectations," and everybody rushes to dump the stock. The bad news is flashed around the world instantaneously on the net and on TV. The stock drops 30% overnight. This isn't investing, it isn't anything but playing the "greater fool game," and it works until you find that "Good Lord, I'm the greater fool."

The slaughter in many of the tech and net stocks, and even some of the "good" stocks is shocking. Daimler (Mercedes) with a high of 106 is selling at 57. MSFT with a high of 120 is selling for 68. AOL with a high of 95 is selling for 60. CSCO which had a high of 81¾ is selling for 69. CMGI with a high of 163 is selling for 50. IBM with a high of 139 is selling for 102. BMY with a high of 79 is selling for 49. KO with a high of 88 is selling for 50. This list goes on and on and on. **Attrition? You bet it is.**

Ironically, the only Dow Average which is UP for the year is the **D-J Utility Average.** Why? Well, one reason is that the D-J Utility Average is selling at 15.7 times earnings while yielding 4.07%. Hardly a bargain by historical standards, but certainly a bargain compared with any of the other averages, including the Nasdaq and the S&P.

This market, ragged as it is, hasn't given us many hints as to what to expect in coming months. However, there is one phenomenon which I want to discuss. It's the strange pattern in the Dow (see chart on this page.)





Here we see the formation of a "broadening pattern," the classic pattern of indecision. The broadening pattern is a five-point reversal pattern with each high above the preceding high and each low below the preceding low.

The Dow has now run through 4 points with a possible point 5 ahead. If the Dow can advance to a point 5, it will have to advance to a new record high. We see the initial attempt to advance to point 5, but that attempt halted on April 11 at 11287. The Dow then broke down to a low of 10307 on April 14.

The Dow is now fluctuating between the 11287 high and the 10307 low. Breaking out either way will be highly significant. The Dow is also above its 200-day moving

average, which currently stands at 10686. The fact that the Dow is holding above its 200-day MA must be considered a plus.

I'm particularly interested to see whether the Dow can muster the strength to complete its leg to point 5 -- or even if the Dow can advance to a new record high above 11722.98. We're now in the area where the Dow will show us, one way or the other, how strong (or weak) this market really is.

INVESTMENT POSITION: The bear still rules the box. The following is sort of a repeat of a piece I wrote April 26 on the web site.

I continue to like the bonds. Here's why. Somewhere ahead we're going to get an economic downturn. The downturn will come with US consumers holding a record load of stocks and at the same time consumers will have record low savings. In other words, it will be the absolute worst time for consumers to deal with a downturn.

The downturn will come either from a bear market in stocks or consumers simply pulling back on their buying or from some other unknown source. The Fed knows that a downturn in the economy will turn into a disaster for the typical American. For this reason, I believe the Fed will attack the downturn with every device at their command, and that will obviously include expanding the money supply plus driving interest rates down.

If the Fed has to drive long rates down to 4%, 3%, 2 ½%, that's what they'll do. They will fight the downturn "tooth and nail." This should result in a massive rise in the bonds (and obviously in the longest-dated bonds).

But when will the downturn come? Who cares, you're getting paid nicely while you wait, which is more than you can say for stocks.

Interestingly, investors have been pulling billions of dollars out of bond funds over recent months while plowing this money and more into equity funds. My feeling -- they're going to be wrong on both counts.

Conclusion: buy Treasury ten-year notes, long Treasuries and the best-rated muni bonds, preferably bonds from your own state.

DIVIDENDS: An article in the *NY Times* tells an interesting and significant story. For the first time since the Depression, 25% of the value of the S&P is made up of stocks that pay no dividends. Twenty years ago, only 2% of the S&P was made up of dividend-less stocks.

Question: How do companies "get away" with not paying dividends? (1) The argument is advanced that companies know better how to utilize their cash than their stockholders, who might have been receiving this cash in the form of dividends. (2) After 18 years (since 1982) in which the Dow has never closed below the low of a preceding year, stock-buyers are convinced that stocks can only go UP. Consequently, "who needs dividends when stocks are literally guaranteed to generate capital gains year after year?"

And the Russell comment is that all this is predicated on an ever-rising stock market. The average yield on the S&P is now just above 1%. If your stocks are rising at say a 7-15% rate every year, the 1% in dividends becomes inconsequential. And it's true, a stock yielding 1% certainly isn't worth buying for income.

But what happens to the "dividend-less" stock if a bear market hits? No problem, say the neophytes, "We just sit tight with our stocks and within a few years the market will be back at the old highs and then to new highs, so what's the problem?"

And the Russell comment is that this type of thinking lays the groundwork for maybe one of the most vicious and long-lasting bear markets ever. Consider this -- most MAJOR bear markets tend to take the Dow back to a yield of 6% or even more. If the Dow was to decline to the point where it yielded 6%, the Dow would have to sink to the 2500s. There is no question in my mind that a 2500 Dow would knock most of today's super-bullish stockholders out of the market -- with murderous losses.

Fat dividends allow for the compounding process. Holding blue-chip stocks or good bonds with yields of 6% or better allows for a steady build-up of assets. The only thing needed is **time.** Buying stocks in a bull market allows for "compression." By compression I mean that a rising stock can beat time (beat time compared with waiting for your money to compound).

If you could live to be 200 all you would have to do to become extremely wealthy would be to buy top-grade bonds and let them compound. But we don't have that kind of time, so we buy stocks hoping that they'll double and triple in our lifetime or preferably in a much shorter time.

My main point is that the person who buys dividend-less stocks is foregoing the safest and surest of all wealth-building methods -- **compounding.** Few people understand this, and even fewer have the patience and discipline to allow compounding to work for them. Thus, the cult of dividend-less equities, equities that are supposed to rise

forever. For those of you who have never read my piece on "compounding" it appears as a link on the home page of our website, at **www.dowtheoryletters.com**.

NOTES & QUOTES: The reliance of the US on foreign capital inflows is continuing to grow. At over four percent of GDP, the current account deficit has reached its highest level since records began after the Civil War. Writes the *Financial Times*, "If present trends continue, the US will have to sell assets equivalent to Microsoft and General Motors to fund the shortfall this year. This is a time bomb and the only question is when it goes off."

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From David Dreman's "What New Economy?" column in the April 17 Forbes: "Note that the New Economy is a relatively small part of the total economy. High tech was 16% of GDP in 1970, rising to 20% in 1994 and an estimated 25% at present. E-tailers' sales are rising at a spectacular clip. Even so they accounted for only 0.6% of all retail sales in 1999's fourth quarter.

"Let's focus on the e-tailers beach-head, books. In the four years that online booksellers have been in operation, Amazon.com and other Internet sites have captured only 8% of the retail book market. They have accumulated losses in the billions. Hardly the market of a category-killer. While new technology developments are breathtaking, their profitability isn't. At year-end 1999, 400 large Internet-related companies had a market value of $1 trillion (27% of the value of the Dow). This group reported combined revenues of $29 billion; that's only 2% of the Dow's revenues. More tellingly, the Internetters will collectively lose $9 billion this year, while the Dow stocks will probably earn close to $150 billion."

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Received an e-mail from a subscriber who told me that he had met Greenspan many years ago, and in discussing the cycles, Greenspan said that the down cycles in the stock market and the economy could be counter-acted by surges in the money supply. Is that what the Fed is doing today? MZM, according to the St. Louis Fed's charts, has broken out to the upside. Thus it would seem that Greenspan and Co. are trying to keep the boom in stocks going -- well, at least until after election time.

So what we may have now is a battle of wild valuation against a surging money supply. And that violent confrontation may be what's causing the extreme volatility that we're experiencing today.

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I received many questions about the government's so-called stabilization funds, used, supposedly, to turn the market at the April 4 "crash" bottom. A subscriber writes that it would have taken literally thousands of S&P futures to turn the market (each future was worth around $375,000), but the buyers of futures would have had a problem. They would have to either take delivery of these futures--or sell them back into the market. I doubt very much if they would want to take delivery. And if they had to sell them back, there'd be big pressure on the downside again, thereby defeating their purpose. So all in all, I doubt whether that is what happened. But what very well did happen was that Merrill, Goldman, Fidelity, etc., the big guys who wanted to protect their huge investments, these were the one who came into the market and bought the futures or more probably bought stocks. To me, that makes more sense than the theory that the government came in and bought futures to turn the market.

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"Who wants to be married at all?" Various federal agencies say that the number of unmarried families nationwide jumped seven-fold from 1970 to 1998. According to Rutgers University studies, since 1970 the marriage rate has fallen by more than one-third to its lowest rate ever. A recent Rutgers survey showed that 30% of 12th grade girls doubt that marriage makes for a happier life. Statistics also show that men are happier in marriage than women. Also, after divorce, women tend to do much better than men. **Russell Comment:** Women have been given a hard time and been degraded by men for generations. Now that women have more freedom than ever before, they also have the freedom not to get married. My mother was a widow at age 56, and she had many chances to re-marry (she was a very pretty blonde). I once asked her why she never re-married. She said, "I loved your father, and had a very happy marriage, but once is enough. Men are more trouble than they're worth." Many of today's women think, "I'll have kids with this guy, but if the marriage becomes painful, I want to be able to walk away with the least amount of trouble." So for whatever reasons, the marriage rate in the US is plunging.

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Fortune magazine warns, "Don't be fooled by those lofty mutual fund gains -- what counts is what you keep." Every time your fast-trading mutual fund sells a stock at a profit, there's a TAX involved. And it's you that pays those taxes. And up to 39.6% at the highest tax bracket. The rate drops to 20% if the fund kept the stocks longer than a year. Example: Fidelity's giant Magellan fund; over ten years their average annual gain was a juicy 19%. But factoring in taxes that investors had to pay, the actual return sinks to 15.9%. Fund managers have little incentive to keep their tax bills down; they get measured by their total returns. But taxes concern fund buyers. A study by the *Journal of Investing* shows that between 1970 and 1995 federal taxes took 44% out of the typical stock fund's performance.

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According to Forrester Research, Inc. of New York, most retailers that operate entirely on the Internet will be out of business by next year. The fallout has already begun. Lawyers and consultants are getting swamped with calls for help from companies in distress. When the e-tailers first emerged a few years ago, they thought that cyberspace would be big enough to do business whether you are a Wal-Mart or an entrepreneur selling jelly and jams. Some of the

traditional chains such as Wal-Mart and Sears are stepping up their online action, and in my mind that's where the future of e-tailing lies.

"There are 30,000 e-tailers out there, and probably 25,000 will have to go away," opines Mark Doll, a consultant for start up companies at Ernst & Young. **Russell Comment**: Keep your eye on Amazon.com. If AMZN can't make it, who can? AMZN had a high of 113 on December 9. Today it is traded in the 55-57 range, down 50% from its high.

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The free phone call may be on the way. It will come via the Internet. AT&T is close to a deal in which it, and maybe others, will pay $1 billion for a major stake in Internet pioneer Net2Phone, Inc. On March 27 Cisco revealed rival equipment. Merrill Lynch plans to install 5,000 Internet phones from Cisco and Lucent at a site in New Jersey. World traffic from Internet voice traffic is now tiny, about $600 million in 1999 compared with $650 billion in traditional phone traffic. Says Cisco's Martin DeBeer, head of marketing for Cisco's Net telephone products, "In my five years at Cisco, I have never seen as much excitement as I have seen over Net telephony."

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The Dutch have huge financial holdings in the US. They also have one of the friendliest and most flexible tax systems in Europe. As a result, hundreds of "flag-of-convenience" companies, including the subsidiaries of multinationals such as Nike, Sony, Gap, Mitsubishi, Cisco, IBM, AOL, and even Gucci and the Rolling Stones rock band are centered in Holland.

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Who are the largest corporations in the US in sales? Here they are: GM $189 billion; Wal-Mart $166 billion; Exxon $163 bils.; Ford $162 bils.; GE $111 bils.; IBM $87 bils.; Citigroup $82 bils.; AT&T $62 bils.; Philip Morris $61 bils.; Boeing $58 bils.; Bank of Amer. $51 bils.; Boeing $58 bils.; SBC $49 bils.; Hewlett-Pack. $48 bils.; Kroger $45 bils.; State Farm Ins. $44 bils.; Sears $41 bils.

The big two sectors in sales in the US are cars and houses. The rates will soon be squeezing the housing market. Proof is the trend of lumber, which was down to 301, breaking the low of last October when lumber was 312 (lumber was 345 in February.)

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The two nuttiest phenomena of this market. **(1)** The new thesis that when a market is down 10% or more, "it's a correction." When the market is down 20% or more, it's "a bear market." I keep wondering who dreamed up these two goofy definitions. **(2)** The mindless emphasis on quarterly earnings. Instead of looking at a stock's price in relation to average earnings over a period of time or the discounted value of whatever a stock can throw off in the future.

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According to a Federal Reserve study, stockholding now accounts for a greater percentage of household wealth than ever before: stocks now account for one-third of household wealth. This gives you some idea of why Greenspan is dealing so gingerly with rates and with the market.

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Despite stock market troubles, greed reigns supreme. I've read at least three articles in which young ladies are invading Silicon Valley in the hopes of capturing an e-millionaire. *Elle* magazine (May) feature an article, "Single-Gal Heaven" in which "Deanna Kizis' ventures into IPO country to date five millionaires in five days." The April 10 issue of *New York Observer* features a full-length article entitled, "How to Marry an E-Millionaire."

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According to the *WSJ,* as of mid-April First Call tracked 28,000 stock recommendations. Of these, 67% were "buys" or "strong buys," 32% were "neutral," and just 0.9% were "sells" or "strong sells." On top of that, over January, February and March, almost $120 billion has poured into stock funds.

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A new book has been published which contains many photos of the lynching of blacks. Lynching, like the actions of the KKK, was done to "keep the Niggahs in their place." Now another book has been published entitled, "Billy Holiday, Café Society, and an Early Cry for Civil Rights." The book revolves around a song which Billy Holiday sang called "Strange Fruit." The song was about lynching in the South, and the "strange fruit" was the lynched body of a Negro "hanging from the poplar tree." The song was explosive, containing the description, "the bulging eyes, the twisted mouth" (I still remember those words). Radio stations wouldn't play the song, considering it too explosive. Columbia records wouldn't release it. The song was considered too depressing even for civil rights protesters, who preferred "We Shall Overcome." I heard Billy sing "Strange Fruit" many times at Café Society downtown or at Kelly's Stables on 52nd Street. It became Holiday's signature song, and crowds shouted to hear it. Last year *Time* designated "Strange Fruit" the best song of the century. A British magazine called "Strange Fruit" one of the "ten songs that actually changed the world." The book notes that "Before she began (to sing 'Strange Fruit'), all service stopped, waiters, cashiers, busboys were all immobilized. The room went completely dark, save for a pin spot on Holiday's face. When she was finished, the lights went out and she walked off the stage, and no matter how thunderous the ovation, she was never to return for a bow." It's all true, I saw it happen many times.

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Politics: This from last week's Evans & Novak column: "Presidential 2000 Outlook: The current Gallup poll for CNN and USA Today shows a surprising 9-point lead for Texas Gov. George W. Bush against Vice President Al Gore. But you would never know it judging from the

political atmosphere in Washington: overriding Democratic confidence, suffocating Republican pessimism. . . Gore has "transformed his image from a wooden policy wonk into a tough, relentless campaigner. Gore is certainly not loved, but he has become feared. . . . Bush has lost his stature among Republicans despite his gritty performance in beating off McCain. Oddly, Bush has actually lost ground with the Republican establishment, and is under pressure to reach a reconciliation with McCain." **Russell Comment:** I think Evans and Novak are the best and most realistic of all the political commentators.

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This is from Robert J. Samuelson's column of April 20. "What counts more is the psychology of the American consumer. Almost everything that's supposed to be 'new' about the New Economy has happened before. Despite computers, productivity gains were larger in the 1950s than in the 1990s. Unemployment was lower in the late-1960s than now. The one truly distinctive feature of the New Economy is that consumers, as a group, have virtually stopped saving. In 1991, the personal savings rate (savings as a share of after-tax income) was 8.3%; in 1999 it was 2.3%. Every percentage point drop in the savings rate is worth about $66 billion in extra consumer spending. Americans may still make deposits in savings accounts or 401(k) plans. But consumers offset these savings by borrowing or by spending stock profits. It is this spending spree -- based heavily on people's stock wealth -- that has expanded the economy, profits and hiring. . . If the market doesn't upset consumers, the boom continues. If the market terrifies consumers, the boom stops. Between those two extremes, there are endless possibilities. Wall Street is main street."

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I think water is going to be one of the critical problems for the 21st century. The following is from the May *Time* magazine: "Freshwater: These are the most critical of ecosystems since all organisms need water to survive. Human water consumption rose six-fold in the past century, double the rate of population growth. People now use 54% of available freshwater, and additional demand will further jeopardize all other ecosystems." (Russell comment: this is one of the reasons I like the US's largest private water company, American Water Works (AWK).)

THE GOLD STORY: Despite increasing signs of inflation, gold remains dead in the water. Silver, barely holding above five dollars, isn't doing much better. What's wrong, or what's happening? The main thing that's happening is that the dollar is super-strong.

Let's face it gold-philes (and I personally LIKE gold), if the dollar is strong and if the dollar pays interest, who needs gold? Well, nobody who owns dollars or dollar denominated assets needs gold, but most of the world doesn't own dollars, so they need gold or at least could use it.

The euro has dropped "out of sight" against the dollar, so Europeans certainly would have been better off holding gold than holding the euro. But gold for Americans is priced in dollars, and so far, there's no reason for Americans to rush in and buy gold. And that's the problem, at least for you and me at this time.

As far as palladium and platinum, they're largely a function of how much the Russkies want to ship. Platinum at 455 an ounce is currently priced better than 60% above gold. Darn, I should have bought more of those Isle of Man one-ounce platinum coins and fewer Krugerrands. Who knew, I didn't. As for the gold shares, they sure seem cheap, but so far they've been locked in to "nowheres-ville."

LATE NOTES: Listening to CNBC this morning I heard one analyst saying that "The Dow will be above 12500 by year end." What nonsense. This guy has no more idea of where the Dow will be on December 31 than the proverbial man in the moon. What he should be looking at is the current technical and psychological situation in the market, while keeping all his goofy predictions to himself.

Floyd Norris (the *Times'* top veteran analyst) in the April 28 *NY Times* opines that only two things will knock this market down -- a crumbling dollar or an economic downturn. A business downturn, he says, will force the market to follow the economy down.

What, the economy leading the market, actually surprising the market? It doesn't work that way. Here's what I think is really happening. I think that the stock market has already sent out subtle (subtle because they are being ignored) danger signals. Remember my top-out parade? None of the major averages are at new highs. How about the majority of stocks? The advance-decline ratio is now less than one-point away above its March low. As for the PTI, it remains in its bear mode. The bear, as I see it, has even been able to fool Floyd Norris of the *Times*.

Attrition, erosion, that's what's been happening in the market, so far. The bear, devil that he is, has given the public a long-lasting shot of Prozac. People are still feeling good. This despite all the damage that the market has sustained. Remember, a bear market doesn't have to start with a dramatic crash. Hardly, a bear market starts any way it wants, but preferably **it will inflict the most amount of damage before anyone knows what's really happening.**

With the latest inflation news, the debate is whether the Fed will raise rates .25% or .50%. I think .50% is already priced into the bond market. Has it been priced into the stock market? I'm not at all convinced that it has.

NEXT MAILING: May 24, 2000